

Approved as Submitted: December 4, 2002

**CITY OF MORGAN HILL
SPECIAL CITY COUNCIL MEETING
MINUTES - NOVEMBER 13, 2002**

CALL TO ORDER

Mayor Kennedy called the meeting to order at 7:04 p.m.

ROLL CALL ATTENDANCE

City Clerk Torrez certified that the meeting's agenda was duly noticed and posted in accordance with Government Code 54954.2

SILENT INVOCATION

PLEDGE OF ALLEGIANCE

PUBLIC COMMENT

Mayor Kennedy opened the floor to comments for items not appearing on this evening's agenda. No comments were offered.

OTHER BUSINESS

1. SEWER AND WATER REVENUE REQUIREMENTS

Director of Finance Dilles presented the staff report and indicated that John Farnkopf with Hilton Frankopf and Hobson, LLC was present to make a presentation of the Water & Sewer Fund Revenue Requirements Study.

Water

Mr. Farnkopf addressed the City's water fund as it relates to revenue and expenditure requirements.

Mayor Kennedy stated that the City just completed a water and sewer system master plan and that it was his understanding that water impact fees for new installations would take care of the expansion system. He inquired why fees are being proposed to be transferred if this is the case?

Mr. Frankopf responded that fees are based on full cost recovery. He said that there is a cash flow shortfall and that funds are not coming in quick enough to cover the cash flow shortfall. He said that in order to cover the cash flow shortfall, a loan would be required and that it would be repaid from the impact funds. He indicated that during the five-year project period, the funds would "square up."

City Treasurer Roorda inquired how volatile are the water purchase rates and how predictable are they over time?

Mr. Frankopf responded that the increase is based on a gradual trend at approximately 2% rate of growth, therefore, it is averaged out. He said that the climate will affect the rate of growth.

Mr. Dilles said that should the Water District increase water rates above the inflation rate, staff would need to return to the Council with additional rate adjustments.

Mr. Frankopf indicated that there are four water funds: operations, rate stabilization, capital projects and impacts funds. He addressed each fund category.

City Treasurer Roorda recommended that the minimum coverage be made in order to cover debt cost.

Mr. Frankopf indicated that none of the funds identified are proposed to cover debt but that they can be used for debt coverage.

Mr. Dilles said that a lot of investors insist on a certain amount of coverage and want to make sure that there is enough revenue coming in over and above debt service requirement. He said that the minimum amount of reserves meets this requirement.

Mr. Frankopf said that the 25% is the operational amount driven by lead leg time; this being the time the City incurs cost and when it will be paid by the City's customers (approximately 90 days lag time needed to have sufficient reserves to cover). He said that the reserves are not intended to meet gradual rate increases but are to be used for unusual circumstances. He noted that the City is using the rate stabilization account to hold water rates down.

Finance Director Dilles stated that there is some flexibility between the rate stabilization, capital projects and operational funds and that the Council will typically see some transfer of funds each year between these three funds. This is done in order to meet daily operations and to meet the minimum reserves. However, he said that the impact funds are restricted as they are to be used for costs associated with development.

Mayor Pro Tempore Carr said that he understood why there are minimum reserves in all funds. He did not understand why there is a large amount of combined funds in reserves that equate to \$4.8 million to cover an unexpected event.

Mr. Frankopf stated that the water operation reserve should be maintained at a minimum balance. He said that the other funds are at a comfortable balance. The consequences in letting the balance go to zero is not a major concern but would mean that there is less of a buffer before the City would need to increase rates.

Mayor Kennedy inquired as to the capital projects that are causing the huge expenditures of reserve funds and questioned whether these are projects that need to be completed at this time?

Director of Public Works Ashcraft responded that most of the capital projects were budgeted two years ago and were continued to this year. These include four water reserves and replacement of a telemetry system. He identified other five-year capital improvement projects that are planned in the future, noting that a lot of the capital improvement projects were for fiscal year 01-02 and have been carried into fiscal year 02-03.

Mayor Kennedy said that instead of bonding for the capital improvement projects that the City is self funding them through reserves from the water rates.

Mr. Dilles stated that it is the existing population that is causing the increase in rates and the need to perform the capital projects. He said that staff is comfortable with a 45% (20%/25%) reserve because in the long term, staff does not want to see rate spikes. Staff would prefer to see a smooth rate structure over time so that it does not impact the community too much at one time. Thus, the reason for the recommendation to keep the amount of reserves as being recommended.

Council Member Chang noted that the City would need to go out for bonding and go into debt service if the City does not want to use the reserves.

City Manager Tewes indicated that capital projects come out of the master plan that gets translated into Capital Improvement Programs (CIP) that in turn gets translated into revenue requirements. He said that the rate base will pay for the capital projects. The reserve policies are established for comfort, safety, cash flow needs, and are not proposed to finance future capital projects.

Council Member Chang inquired whether staff included funds for future capital projects with the proposed rate increase?

Mr. Frankopf responded that the proposed rate increases are a means to generate a fairly stable stream of revenues which includes a transfer into the capital projects fund. He said that the capital reserves would be used to pay for capital improvements.

City Manager Tewes noted that the current year includes a high and unusual level of capital expenditures. After this year, there would be a more regular rate of capital expenditures.

Mayor Kennedy noted that the City used reserves to pay for capital projects. He inquired if it would make sense to include triggers built into the reserves so that if the City is to go under the target reserves caused by such things as drought conditions that would not automatically trigger rate increases but trigger discussions on rate increases when a threshold is reached.

Council Member Sellers noted that you need to leave the county to find citizens paying more than

Morgan Hill rate payers. He inquired as to the reason Morgan Hill citizens are paying higher water rates?

City Manager Tewes said that the differences between Morgan Hill and Gilroy's system is that Morgan Hill has six or more pressure zones than Gilroy. Therefore, Gilroy has less pumping needs. Also, Gilroy has a less rigorous capital investment program.

Mr. Frankopf noted that three alternative options were being presented for Council consideration: 1) 2% annual rate increases to bring the balance to the upper end of the target by the fifth year; 2) a single 8% rate increase in 2003; or 3) pay \$1.5 million in capital improvements out of debt. He indicated that he is recommending the 2% alternative as it is a fairly modest rate of increase program.

Mayor Kennedy opened the floor to public comment.

Mark Grzan inquired as to the type of survey that was used to determine the proposed rate structures?

Mr. Frankopf responded that the survey was based on the effective rates from existing ordinances or resolutions. He used a common base to calculate the water bill.

Mr. Grzan stated that he would like to see a mean, median, and mode in terms of monthly costs. He would also like to see a gallon comparison as well as comparison of rates among agencies in terms of gallon utilization. He noted that Morgan Hill utilizes a tiered rate system and wanted to know how these rates compared to that of other agencies such as Sunnyvale, San Jose or Milpitas.

Mr. Frankopf stated that it is hard to make comparisons unless you convert information into a customer bill. He said that 19,000 gallons is the mean for a Morgan Hill single family residential customer.

Mr. Grzan inquired as to the rate structure for multi families. He inquired as to the percentage of Morgan Hill single family rate users.

Mr. Frankopf responded that the rate structure for large multi families is different. He said that 75% of the customers are residential and that he does not have information on industrial rate users.

Mr. Grzan felt that the information presented is lacking and was insufficient to make a decision. He felt that residents need more information/details about their water rates for basing the new rates. He said that he does not get a sense of community use based on the charts presented. He stated that his water bill is not close to the information being presented. He was not sure whether the information was typical for the average Morgan Hill resident. If the rates go up, he felt that the reaction from the public would be to reduce its water usage. If so, this will reduce water rate revenues.

Finance Director Dilles informed the City Council that staff provided Mr. Frankopf with the entire customer list that contained information of the kind of customers the City has and the amount of water usage. He said that there are 12,000 Morgan Hill water customers. Staff looked at how much revenue is being collected and how many gallons of water customers are using in order to come up with a rate structure.

Mayor Kennedy informed Mr. Grzan that the action before the Council is not necessarily to accept the rate structure but to provide direction to staff.

Mr. Frankopf indicated that the proposed 2% rate increase would not elicit much of a response from customers. He said that 8% or greater may solicit responses or concerns from residents.

Council Member Sellers said that the City has reserve funds to use in case of drought conditions. He noted that the community is using greater amounts of water per household the past couple of years. Also, the City has started to see that people are not paying particular attention to the rate schedule. He stated that the rate structure is such that the more you use, the more you pay. It is designed to encourage water conservation, if not, customers will pay for its water usage.

Mayor Kennedy said that the basic rate structure was designed to encourage conservation. The more water an individual uses, the higher the rate levels.

Mr. Dilles said that staff could share the information it has in terms of the number of customers the City has in each category and the revenues contained in each category with Mr. Grzan. He stated that it gets difficult to compare the City to other cities as it is a pain staking process to try and obtain this information. With Council direction, staff can conduct a city survey but that it would take effort to obtain the information.

Mr. Grzan requested that it be asked if other cities subsidize water rates. He felt that citizens are interested in knowing how the City's water rates compare with other agencies. He felt that it would be important for citizens to know that Morgan Hill water rates are competitive.

City Manager Tewes said that the consultant was only looking at the rate structure and not the tiered structure.

Council Member Sellers noted that there are no geographic variations in the rate structures and that in some geographic areas, it costs more for the City to provide water service than in other areas. He said that this may be something that the City may wish to consider at a future date.

Mayor Kennedy inquired whether it was appropriate for Mr. Grzan to work with staff as a starting point.

Mr. Grzan indicated that he would work with staff to obtain answers to his questions.

Mayor Kennedy recommended that triggers be added and that he would favor a 2% gradual increase versus one big rate increase. He also favored building back up to the higher target reserves.

Council Member Sellers felt that it would be appropriate to lump the operation reserves with the other reserves. He said that the operation reserves needs to be consistent and stable. He said that he was comfortable with the 2% rate increase. He stated that he would like to see a reserve, but not necessarily the reserves as identified.

Mr. Frankopf stated that there are different approaches to water rate structures. One would be for the Council to adopt annual increases and monitor the situation. Another approach would be to adopt a series of rate increases that can be turned off if it is found that they were not needed. He did not believe that the Council could leave the rate of 2% at cruise control.

Council Member Sellers recommended a 2% rate increase for the first years followed by a review.

Mr. Frankopf said that the rate increase has been modeled such that a 2% rate increase would take effect on April 1, 2003 and 2% on July 1, 2003 with the subsequent 2% rate increases in July of each year. The Council would need to determine when it would like the 2% rates to go into effect.

Mayor Pro Tempore Carr inquired where the 8% rate of growth came from?

Mr. Frankopf stated that if you plug in 8% into the model, you achieve the ideal target reserve.

Council Member Sellers expressed concern that the Council is trying to be reactive with rate increases. He felt that the things that would cause rate increases are natural disasters or significant capital requirements. He expressed concern that it may be poor fiscal planning to wait until the money is needed before asking the rate payers for the rate increase. He said that 9 times out of 10, the community would be less generous and less able to take on the sudden increase. He recommended that the City avoid the mistrust that has been avoided by the creation of a stable financial situation. He did not want to talk about rate increases until they are needed. He felt that the City needs to remain prepared for disasters. He recommended that a policy be developed and that the policy be monitored every year.

In response to Mayor Kennedy's question, Mr. Frankopf indicated that a bond indebtedness associated with alternative 3 would require 20-years of debt.

Council Member Chang inquired as to what would happen to the debt after year 5?

Mr. Frankopf responded that the debt service is built in at that point and would be part of the requirement for 20 years. He said that the rate increase associated with this would be 4% over the life of the bond. He said that it would be 20 years before you see a difference.

City Manager Tewes said that it would be appropriate to address why the rates are structured as proposed for the public hearing.

Council Member Sellers agreed that a public hearing should be scheduled to consider alternative 1.

Mayor Kennedy agreed to proceed with scheduling a public hearing. In the mean time, staff to gather additional information to address questions that the public may have. He recommended that the additional information be reported to the Finance & Audit Committee.

Council Member Chang recommended a public hearing for the rate increase and rate structure before the City Council.

Mayor Pro Tempore Carr noted that it was recommended that the Council revisit its rate structure in 04/05 to see if it is on track. He was not sure that getting up to the target reserve is a goal of his. The Council should consider if there are alternatives that would be less painful or more appropriate. He inquired whether two - 3% increases would be appropriate and alternate between years. This would still result in attaining the 6% in 05/06. He felt that \$8.19 million in reserves was too high and that the City may be charging its customers too much. He asked how the City can achieve a level that is close to the target reserve but not at it, leveling off instead of continuing to increase the reserves?

Mayor Kennedy said that expenditures were not made at the same time as the rates were being received. He did not believe that the consultant's recommendation was too aggressive. If you look at the operational fund reserve out to 06/07, it is down to \$63,000. It was his belief that this was the fund that should remain the highest.

Council Member Chang indicated that the normal inflation rate is at 3.5%, noting that the City is only proposing a 2% rate increase. Therefore, it was her belief that this is a reasonable rate increase.

City Treasurer Roorda addressed a perception of the operational fund in that the City has a very seasonal cash flow. He was not sure whether the 25% would get the City through the first year.

Mr. Frankopf said that the reserve is an amount that is based on an average rate of expenditures. He agreed that there is a seasonal variation. He said that the reserves are needed in order to pay for fixed costs. He said, that on average, there is a fluctuation in the fund balance. This is another way to study what the reserve balance would need to be. He has worked with other agencies that are billing customers on a tax roll who receive revenues only once or twice a year. There is a 9-month period where no revenues are collected. These agencies have high operational reserves to cover these long periods of time.

Mayor Kennedy said that this would be another useful graph to view.

City Manager Tewes said that there is a seasonality to the water fund. He said that the variation is not significant in terms of dollars with a 10% variation from the high to the low months.

Mayor Pro Tempore Carr clarified that he was looking at other percentages and not limit it to four years out. He stated that he does not necessarily need to achieve the target reserve being recommended.

Council Member Tate noted that the Council would be establishing guidelines. He recommended a 2% rate increase per year with a criteria being established. Should the City achieve a certain percentage of the target reserve, the Council would not need the 2% revenue. He stated that he would like to see a guideline that is flexible. He did not want to have a 2% increase every year, if not required.

Council Member Chang stated that yearly reviews would not be necessary if a \$4.6 reserve is exceeded.

Council Member Tate said that the reserve caps may be different for each Council Member than that of Council Member Chang's recommended reserve cap. He stated that he did not want to propose rate increases if they are not required.

Mayor Kennedy clarified that Council Member Tate is suggesting that the Council provide staff with a policy direction rather than having them return with more information at the public hearing.

Mr. Frankopf stated that the operating reserve is one that the Council needs to focus on and that the co-mingling of reserves confuses the picture. He said that the capital project reserve is on line. The rate stabilization reserves should be the lowest of the three reserves. He said that the \$3 million would cover the capital reserve and that the rate stabilization fund is more of a buffer to meet shortfalls because of dramatic/economic effects on water demands or other unforeseen capital improvements that are in addition to what is being funded from the capital reserves. He said that there may be a middle ground such as \$3 million that would get the City through the operating and capital expenditures. He said that this amount would give the City what it needs for capital projects.

Mayor Kennedy stated that he would like to incorporate Mr. Frankopf's suggestion of \$3 million in reserves.

Council Member Sellers felt that it would be important to present specific numbers at the public hearing. He felt that Mr. Frankopf's suggestion of separating funds makes sense.

Sewer Rates

Finance Director Dilles explained that the sewer rates are higher in Morgan Hill versus Gilroy's rates and are attributed to carrying affluents from Morgan Hill to the sewer treatment plan in Gilroy.

Mayor Kennedy explained that sewer pipes are more spread out in Morgan Hill and that pump stations are located in the hillsides.

Mr. Frankopf stated that he did not see a need to restructure the sewer rates at this time as the reserves are high enough. If development were to slow down a lot, he said that there would be a need to increase connection fees. He stated that the impact fund reserves are not high enough and include the treatment plant as well as the flushing system.

City Manager Tewes said that the impact fees would be collected over the life of the general plan to pay for new growth and shared capacity improvements. When the first increment of capacity is triggered, the City has to build the whole trunk. He said that the cash flow does not track what the cash income is.

Mr. Dilles said that some of the costs of impact fees are recovered for construction and include interest costs.

Council Member Sellers said that in looking at the total rate increases, the City is at \$12 million this year and \$6 million in 05/06 with a target of \$4 million. In looking at the chart, he noted that the City would be 150% of the target in four years. He inquired why a rate reduction was not being proposed at the reserves are at 150% of what would be needed four years from now?

Mr. Frankopf responded that target reserves do not anticipate additional back stopping of rate revenues to cover debt services if the City does not achieve a rate of development.

City Treasurer Roorda expressed concern that if you look at the deficit and how it grows each year that it is at a 10%-15% range of revenue requirement. He said that the City would be reducing its reserves. If this occurs, it was his belief that the City would be close to the deficit line and that the City would be setting itself up for a huge rate increase.

Council Member Sellers inquired if there was a rate reduction that the City could consider this year and that the City look at the rates 4 years from now?

City Treasurer Roorda expressed concern with the current rate and when the crossover would occur as the City would then need to fund 15% of the rate increase.

Mayor Kennedy inquired about the possibility of lending some of these reserves for parallel trunks versus bonding for the full \$8 million, reducing the reserves?

City Manager Tewes noted that the amount of expenditure is greater than the amount of reserves. If and when the City issues debt, the City would be looking at all numbers regarding the use of cash reserves in order to reduce the over all cost of the program.

Mayor Pro Tempore Carr referred to page 21, the reserve fund balances. He said that it is being stated that the top end of the reserve of the water fund may be too high and that the City may want to prioritize these funds to lower them. He said that it appears that the City may need to do the same thing with the sewer funds. If this is the case, he felt that the target zone should be lowered.

City Manager Tewes felt that the risk in the sewer funds is greater than the water funds and are attributed to high power cost, technology, and regulatory requirements.

Council Member Sellers inquired if a public hearing would be required if sewer rates were not being proposed to increase?

City Manager Tewes responded that a public hearing would be required for adjusting rates up or down.

Council Member Sellers recommended agendizing consideration of whether or not there should be a change in the sewer rate structure.

Mayor Kennedy stated that he would be interested in taking a look at using some of the reserves for bonding of capital services as a loan or some thing of this nature versus reducing services. He recommended that the Finance & Audit Committee take a look at this.

City Manager Tewes felt that the economic effect would be the same if you borrowed from the capital markets for revenue bonds or whether the City collects from rate payers.

Council Member Chang inquired as to the rate required to keep the reserves at the level being addressed?

Council Member Sellers indicated that the City could increase sewer rates to 8% in one year or increase the rates at 2% for four years, similarly as is being proposed for the water rates. He recommended that the City split the difference and not wait until 05/06 to increase the sewer rates.

City Manager Tewes noted that Mayor Kennedy suggested that triggers be established or red flags be identified that would necessitate Council review of the rate structure. If the rates appear to be dropping faster than anticipated, the rates could be increased sooner. It may turn out that the rate increases may not be necessary for 3-4 years.

Mayor Kennedy inquired if Mr. Frankopf studied what decrease in rates would bring the City to the target reserve by 06/07?

Mr. Frankopf said that decrease in rates would increase the deficit at the same time. He said that one way to look at this is to determine what rate of decrease, on a one time basis, would get the city to a target rate at 06/07. Another way to look at this is what would be the annual rate decrease that

would achieve the appropriate target level. This alternative would be a gradual way to achieve the target level. He indicated that borrowing is related to the expansions.

Mark Grzan felt that there must be a reason why the City cannot take the excessive sewer reserves and place them in the water reserves. He said that Council direction appears to be reaching a target reserve. He said that it seems that one of the Council's considerations this evening is to move quickly toward the water target reserve with a heavy impact. He felt that the Council should also be looking at bringing the excessive reserves in line with the target for sewer to be consistent. If the sewer reserve is not where it should be, the Council should adjust it. By keeping the reserves at a higher amount than required appears to conflict with the Council's plans for water.

Mayor Kennedy recommended that the Council refer the issue of looking at sewer rate decreases to the Finance & Audit Committee, working with staff to see if it makes sense to proceed with a rate reduction.

Council Member Sellers said that should the Finance & Audit Committee find that no change is needed in sewer rates, that this recommendation return to the Council.

Council Member Tate stated that he has not convinced himself that reducing the sewer rates was the right thing to do as an inherent risk exists. He was not comfortable in considering a rate reduction when there is a possibility of a rate increase in future years. He felt that sewer rates were more volatile than water rates.

Council Member Sellers said that he would like to look at a rate reduction this year and then an increase in another year, smoothing out the rates.

Council Member Chang said that the goal should be to have a zero deficit with a reserve at a certain level.

City Manager Tewes noted that with the water rates, the Council indicated that it would like staff to schedule a rate increase for public hearing and that staff is to analyze certain options that relate to certain targets for each of the water reserve funds. With respect to sewer, the Council has referred this matter to the Finance & Audit Committee who will report back to the City Council with a recommendation of whether or not to adjust sewer rates.

Mayor Kennedy stated that he needed more information relating to the fact that the sewer rate structures and expenditures are more volatile and elaborate.

Mayor Pro Tempore Carr stated that he would like to look at the direction the Council is headed with regards to sewer funds to see if there is an opportunity to lower these rates on a short term basis. He asked if it would be a benefit to having this item return to the Council versus sending it to the Finance & Audit Committee as he would hate to lose information.

Mayor Kennedy stated that he would support having the sewer rate structure returning to the Council in a work study session.

City Manager Tewes said that the Finance & Audit Committee could review the sewer rate structure and that the item could be scheduled for a council workshop.

Mayor Pro Tempore said that when he served on the Finance & Audit Committee, the Committee did not have enough time to do the things that it had to do without having the Council assigning the Committee new thing to work on.

Mayor Kennedy noted that the Council recently amended its meeting schedule to accommodate a one hour meeting by the Finance & Audit Committee.

Action: *The Council **Reviewed** the Water and Sewer Fund Revenue Requirements Study, **Evaluated** Sewer and Water Revenue Alternatives, and **Directed** staff as follows: Water Rates: Staff to analyze the target zone for each of the reserve funds and then determine their cumulative effects. Staff to **Schedule** a public hearing. **Sewer Rates:** **Referred** this item to the Finance & Audit Committee and **Directed** staff to schedule the sewer rate structure for a city council workshop session.*

2. UPDATE ON BUDGET AND REVENUE FORECAST

Finance Director Dilles presented the staff report.

Council Member Sellers stated that he assumed that department heads gave consideration to what might be included in the 4% budget reduction. He said that he was not sure that he would support cuts in certain areas unless he had an idea as to the cuts being proposed by staff.

Finance Director Dilles said that department heads discussed what items could be cut. He said that staff wanted to give the City Manager discretion in reducing the budget in areas where it is most applicable. He said that initially, staff felt that it made sense to reduce the budget by 4% across the board as it did last year. However, it was found that at a certain threshold, it does not make sense any more because some programs may be more valuable than others and that it may be easier to cut more from a larger department versus a smaller department. Staff would like the discretion to manage the budget in order to find other areas to be cut that would minimize departments or services to the community.

Council Member Sellers said that he was not interested in the details of the proposed cuts at this time, but that he was trying to figure out whether the proposed cuts are counter to the initiatives that the Council has stated. He asked if staff was making the cuts because they are appropriate or whether they are being made to share the pain, even if they are counter to what the Council has set forth (e.g., not filling positions or cutting programs).

Finance Director Dilles informed the City Council that only cuts in the general fund are being proposed and not in the Community Development funds.

City Manager Tewes informed the Council that staff is suggesting a set of guidelines about how to achieve the 4% savings. He said that staff is not recommending cutting 4% because it is appropriate to do so, but that it is necessary to do so. He stated that staff is looking at departments who were looking to expand a level of service or provide a new level of service. Staff will look at position vacancies and hope that through normal attrition and careful monitoring of positions there would be additional savings. He indicated that this may have marginal impacts. Staff will be focusing on internal services before impacting the community. If enough money is still not found, adjustments will need to be made that might have marginal impacts to the community. Staff would like to manage the 4% reduction in a way that would not impact services to the community. He indicated that the Council will spend time reviewing its fiscal goals and establish a long range approach to the budget in January 2003. He said that it appears that one other agency in our county, VTA, saw an increase in the economy, got on the fast lane, and now sees signs of trouble and have slowed down. He said that the City has never been on the fast lane and proceeded on a moderate path in terms of levels of services being provided and is moving slowly to manage its resources. He said that this is attributed to the Council's fiscal prudent planning.

City Treasurer Roorda stated that he interprets what the City Manager as stating that there would be less cost with the same level of services being provided as an objective. He said that the City Manager has demonstrated that he has been able to achieve cost savings and provide services in the past.

Mayor Kennedy noted that the Community Development fund would not have cuts because they are not dependent on the general fund. This leaves fire, police, recreation, administration and finance who are dependent on the General Fund. He said that the fire department is fixed. It is the police and recreation departments that would probably have to take the biggest hits, noting that these are the two highest Council priorities at this time. With all the recreational facilities coming on line, he did not believe that this was the time to cut back on recreation operating expenses. He felt that dipping into the general fund reserve in the amount of \$187,000 is very minimal and that he would support staff's recommended actions.

Mayor Pro Tempore Carr asked why staff is not recommended an even deeper dip into the reserves?

Finance Director Dilles said that staff felt that it would be appropriate to try to manage the budget down as best it could without significantly impacting services.

City Manager Tewes said that staff cannot forecast when the current downturn will end and that staff is proposing a prudent course in managing its finances because the City may need to bring down its expenditures over the long haul. If staff had seen that the recession would be over and the economy was improving, staff would not be making this recommendation. He felt that it was prudent to use

some of the reserves and start reducing expenditures.

Council Member Chang asked what is the difference between last year's 5% reduction and the proposed 4% budget reduction this year?

Finance Director Dilles responded that the 5% reduction was carried into this fiscal year. He said that the budget levels were kept low this year except for police and recreation services. He noted that supplies and service costs have gone up as well as salaries. He said that staff is proposing deeper cuts with this recommendation.

Council Member Sellers stated that he was comfortable with the proposed action as long as it is understood that there would be a review of the budget in January. If there appears to be cuts that are excessive as part of staff's proposed 4% budget reduction, the Council can evaluate the situation. Conversely, if the situation appears to be getting worse, the Council can discuss the appropriate actions to take.

Mayor Kennedy stated that he was also comfortable with the recommended actions. He responded to the question of why not dipping further into the reserves. He stated that situations do not drastically turn around once you reach the bottom. He felt that this is the appropriate action to take and that the City needs to start cutting its expenditures, particularly since the economic future is so uncertain. If there was certainty in what is to happen in the future, he would be open to dipping further into the reserves. He supported the concept of a fairly high percentage of belt tightening as part of this action as this is a good balance.

Mayor Kennedy opened the floor to public comment. No comments were offered.

Action: *On a motion by Council Member Chang and seconded by Council Member Sellers, the City Council unanimously (5-0) **Directed** the City Manager to Reduce General Fund Costs to a Target Level of 4% Below Budget; Except Fire and Medical Services, and to Minimize Adverse Service Affects; and **Directed** the Finance & Audit Committee to Explore Potential Revenue Sources for the General Fund*

Action: *On a motion by Council Member Chang and seconded by Council Member Sellers, the City Council unanimously (5-0) **Approved** Using \$184,000 of the General Fund Reserve Designated for Economic Uncertainty to Finance the 2002/2003 Budget.*

3. FUND RESERVE AND DESIGNATION POLICY

Director of Finance Dilles presented the staff report. He indicated that property taxes were not incorporated. He said that what was reviewed were the volatile taxes, indicating that property taxes tend to be more stable.

Mayor Kennedy recommended that property taxes be included in the formula as what is being presented appears to be conservative.

Council Member Tate indicated that the Fund Reserve and Designation Policy was designed to be conservative. He said that the Finance & Audit Committee focused on this policy as what should be the Council's guideline. He did not focus on what the Council would do based on the fact that there is a \$4 million surplus. He indicated that the Committee only looked at this from a policy stand point in terms of the amount of funds the City needs to get by as opposed to the 50% reserve established a year ago. The Committee did not consider what to do with the left over funds. He felt that the left over funds could be used as part of the operating budget but felt that it would be better to use these funds to endow a fund such as parks maintenance.

City Treasurer Roorda indicated that he viewed the policies as guide rails to assist the City in tough times. The Committee established certain reserve levels to achieve. He indicated that the Committee also talked about a method to repay dollars that are taken out of the fund when economic times are better. It is hoped that future councils would deal with this policy appropriately and maintain the funds. The Committee felt that the policy would provide guidance over a period of time and that it would make prudent sense to identify how much money can be taken out of the reserves and for what reasons.

Mayor Pro Tempore Carr indicated that the proposed policy stemmed from the budget adopted last June. The Council had discussion on how to apply some reserve funds within the fiscal year budget. He said that the Committee was looking for something that would shape into a guide as the Council looked at the growth and use of the reserve funds. He felt that staff has brought back some good suggestions for Council consideration.

Council Member Chang inquired as to how the percentages of reserves were derived? She said that the Council spoke about looking at a six-month general fund reserve. She said that a financial advisor would state that every household should have at least six months in operating finances in reserves. She noted that 25% would cover three months of operating expenses.

Finance Director Dilles said that 60 days and 17% came from a rule of thumb. It was felt that a percentage needed to be identified and the question was how much reserve would be appropriate. The 17% is intended to buy some time to address issues that may come up. If an issue does come up, the City would have 60 days of expenses. He said that it would be likely that the City may experience a partial disruption and therefore would have more than 60 days of operational abilities. He said that there was nothing definitive about the 60 days and that it is a judgement call. He said that other cities have different amounts of reserves, noting that the recommended reserve is on the high side compared to other cities that he has worked for. He felt that 60 days of reserve was a sufficient amount but that the City still needs to look down the road, manage its resources and stay within resources.

Council Member Chang inquired how quickly can the City react should it lose 33% of its revenue from the State?

Mayor Pro Tempore Carr indicated that the Committee felt that 17% in reserves and 60 days would buy the City reaction time. He felt that 17% in reserves would last a lot longer than 60 days. He said that the way this Council and the management team have reacted in the past, it was felt that 60 days was a prudent amount of time to react and make a judgement to a given situation. He felt that the City has a better planning horizon to what the State may do to the City versus an emergency situation that may occur.

Council Member Sellers felt that the reserves would be impacted by the economy and not by what the State does. He said that a 30% reduction from the State would not result in a 30% reduction in the City's budget.

City Treasurer Roorda indicated that at a 25% State reduction, the 17% would last six months.

Council Member Chang said that in looking at the numbers, she would not want to use all of the \$11+ million in reserves. She indicated that she would not mind using some of the reserves, noting that she did not object to use of some of the reserves in the action taken by the Council earlier this evening based on the current situation. However, when you look at the uncertainties for the next six months, she felt that the City should be looking at the debt service issue as well. She stated that she would support using some of the reserves but keeping them at 50%.

City Treasurer Roorda said that should the Council establish a large dollar amount in reserves, a future Council may be less prudent and would drain a larger amount of funds if a policy is not in place.

Council Member Chang stated that at times like this, the last thing the Council should do is increase the level of service delivery.

Mayor Kennedy stated that he would support reducing the reserves somewhat, but that he would be concerned about going as far as is being recommended. He recommended the percentage in reserves be applied incrementally.

Council Member Chang noted that at the end of five years, there would be a \$1 million deficit in the operating expenses because the budget would decline.

Council Member Sellers noted that the policy would not be instituted immediately. He said that it would be a policy matter that would take affect next year to the extent that the City continues to see an economic downturn. If there is to be an economic turn around, there would be a \$4 million reserve.

Council Member Chang noted that the State would be experiencing a \$15 billion state deficit. She felt that the next two to three years would be difficult ones. She recommended that the Council wait for the issues to settle before spending money.

Council Member Tate noted that this is only a policy and not a mandate to utilize the reserves.

Council Member Chang felt that once the policy is adopted, it would apply to next year's budget.

Council Member Sellers stated that he was comfortable with the recommended policy as he felt that the reserves have been too high and that he continues to feel that they are too high. He did not believe that it is was prudent to keep the reserves too high.

Action: *Council Member Sellers made a motion, seconded by Mayor Pro Tempore Carr, to **adopt** the measures as recommended by staff.*

Council Member Tate felt that the policy was a good one and that the 17% was subjective. He would be willing to increase the percentage to a higher amount that would satisfy the Council's comfort level. He also stated that he was comfortable with the 60 days of reserves but that he would be willing to consider an alternative.

Mayor Kennedy indicated that he could not support the motion as stated. He offered the following amendment to the motion: increasing the percentages for emergency reserves to 17% and economic uncertainty to 17%. This would change the total identifiable reserves and designations of the general funds to approximately \$8.7 million with a remaining projected unallocated fund balance of less than \$2 million

City Treasurer Roorda said that in order to maintain the reserves as recommended would result in the Council adding to the reserves in the future, even if the City was facing good economic years. Should the City find itself in a forced budget situation, the Council would be potentially restricting services to increase reserves.

Council Member Chang said that the policy can be changed, if necessary. She noted that the City would be taking 40% out of its reserves. She felt that once you take the \$4 million out, it is lost. She noted that the City is at 60% reserves (\$11.2 million).

Mayor Kennedy inquired as to the policy's recommended balance? He inquired how much of a surplus over the policy recommended reserve would the City be at?

Council Member Chang responded that the recommended policy would leave a 20% reserve.

Mayor Kennedy noted that a 50% reserve would be approximately \$8 million, noting that the City has almost \$11 million in reserves. This results in approximately \$3 million in excess reserves over

the current policy. One suggestion would be to stick to the current reserve policy.

Council Member Tate did not recall that the Council adopting a reserve policy and that the Council felt that it needed to have a 50% reserve.

Mayor Kennedy felt that a Council statement is in fact a policy.

Action: *Council Member Sellers called for the question.*

Mayor Kennedy noted that Council Member Sellers called for the question. He indicated that it takes a four Council member vote to call for the question. Therefore, the Council would continue its discussion.

Council Member Chang recommended a lower percentage rate, not necessarily 50%. She expressed concern that the reserves would disappear if the policy is adopted. She was not sure if the policy was being proposed to address economic bad times or whether it was being proposed to increase levels of service.

Council Member Tate responded that the Finance & Audit Committee did not discuss the use of the reserves in great detail. However, there was discussion of endowing other services.

Mayor Pro Tempore Carr said that at time of discussing and passing the Fiscal Year 2002-03 budget, the Council had difficulties as it talked about using different reserve funds. Included in the discussions were the appropriate use of emergency funds and the economic uncertainty funds. He stated that the Council had different definitions for their uses. This is what drove the policy as the Council did not have an agreement on how to use the different designated fund reserves. The Committee took a look at how reserves should be used. He felt that it would be appropriate to discuss how to use the remaining \$4 million. He said that the Committee did not discuss lowering the reserves in order to be able to spend more money. He noted that the \$4 million is not a part of this policy. The Committee felt that at a minimum, the general fund reserve level should be one that would assist the City to get through catastrophic situations and that the City would have 60 days to react to the situation. The Committee also looked at other reserve funds, noting that the Commission is recommending increases to these funds. The Committee looked at what it would mean when the economy improves and the reserves grow and how they should be capped so that the reserves are not too high. The Committee did not want to have constituents thinking that their taxes are too high because the City has a large reserve in place that are not being used. He did not believe that the Council should think that it has \$4 million to spend in order to increase service delivery levels or trust funds. He felt that this would be a policy that would instruct Councils on what to do and provide staff with guidance on the emergency funds.

Council Member Chang noted that the discussion started out with regard to using some of the reserves for the current budget. She felt that adoption of the policy would result in an automatic

reaction on where the reserves should go.

Mayor Pro Tempore Carr clarified that the proposed policy, if adopted, would define how the City will use its reserves for economic uncertainties and emergencies with regards to which reserve funds to use. He noted that the Council had discussions in the past on which reserve funds would be appropriate to pull dollars from.

Finance Director Dilles indicated that there is a 50% reserve statement in the budget but that he could not find it as a separate policy.

Council Member Chang noted that a 31% general fund reserve is being proposed.

Council Member Tate suggested a 20%, 10%, and 10% reserve as a compromise. He did not understand the 17%, 17%, and 17% as recommended by Mayor Kennedy.

Mayor Kennedy felt that the economic uncertainty is the biggest risk that the City is facing at this time. He felt that the percentage is a gut feeling and from the “scares” from past times. He felt that more reserves are needed for economic uncertainties and for potential disasters. He felt that the policy is good and supports the language. However, he felt that the percentage numbers being recommended were too low.

Council Member Chang stated that she would support a percentage between 40% and 50%.

Mayor Kennedy said that he would support a 25% general reserve and leaving the other two reserves at 7%, resulting in a total of 39% in reserves. He noted that 90-days equates to 25%.

Mayor Pro Tempore Carr said that a 60-day reserve was one that the Committee spoke extensively about. He felt that the policy is one of a Council comfort level.

Council Member Sellers said that he was comfortable with the numbers, noting that the Committee spent a lot of hours and weeks going over the proposed policy. He noted that the 60-day reserve is higher than what most other cities have and that it is a comfortable level.

Mayor Pro Tempore Carr said that 60 days is higher than what most cities have and that it was felt that 60 days would give the City plenty of time to be able to make adjustments to accommodate different problems. Even if a catastrophic situation occurs where all of the City's income was completely eliminated, and the City decides not to react in 60 days, he stated that there were other funds to draw down as well as the \$4 million. He said that it is easy to state 60 days or 90 days. It was his belief that what this boils down to is one's comfort level, indicating that he has a comfort level with 60 days.

Council Member Tate said that 60 days is an absolute lag when all funds are depleted. He did not

believe that the 60 days would ever happen.

City Treasurer Roorda said that with a 25% reserve reduction it would buy the City 6 months or more to react.

Council Member Chang felt that a 60-day reserve would result in a panic mode. She felt that once you have the money, it would be spent.

Mayor Kennedy said that his comfort level is at 50% reserve and that he would be willing to compromise to bring the general fund reserve to 25% and the other two reserves at 7% for a total of 39% in reserves.

Council Member Sellers expressed frustration that he could not get consideration on his motion as a majority of the Council feels one way about it. He did not believe that the process/discussion should be one that continues until a majority of the Council acquiesces. He felt that the Finance & Audit Committee spent a lot of time on the policy before the Council.

Council Member Chang felt that consensus building was important for the Council.

Council Member Sellers stated that he has a fundamental philosophical problem in taking and holding on to too much of the tax payers' money for a period of time. This resulted in the consideration of a policy. Asking him to compromise in this issue would result in holding onto more of the tax payers' money. He felt that the City is at a reserve level that it should be. He said that he would vote against anything other than what was recommended this evening.

Action: *Council Member Sellers called for this question.*

Mayor Kennedy felt that it was a prudent fiscal responsibility to keep an adequate reserve in times of economic uncertainty. He stated that he would be willing to reduce the reserves to an acceptable level. He said that the build up in reserves is attributed to the Council's frugal responsible management of funds. He was supportive of using reserves for identified community purposes but felt that the City needs to protect itself from over spending in times of economic uncertainty.

Council Member Chang said that it is wonderful time to have this amount in reserves. She said that it would be more comfortable to be able to spend the money and feel that there is room for wiggle and mistakes. She is hoping for a cooperative spirit from the Council in the next two years. She noted that she and Mayor Kennedy came down 10% on this uniformed issue.

Action: *On a motion by Council Member Chang and seconded by Mayor Kennedy, the City Council on a 3-2 vote with Mayor Pro Tempore Carr and Council Member Sellers voting no, **agreed** to amend the motion to incorporate a 20%, 10%, 10% reserve*

ratio.

Action: *The main motion, as amended, which adopts the "Fund Reserve and Designation Policy language with the understanding that it is a 20% general fund reserve, 10% reserve for emergencies and 10% reserve for economic uncertainty. The motion carried 3-2 with Mayor Pro Tempore and Council Member Sellers voting no.*

4. COUNCIL DIRECTION REGARDING SCHEDULING OF SPECIAL MEETINGS

City Manager Tewes presented the staff report. He stated that it is the staff's belief that it can handle the scheduling issue with Council cooperation through the Clerk's office. The Council needs to discuss whether it wants to be involved in all meetings to which it appoints a subcommittee or whether it wants to rely on an appointed subcommittee.

Council Member Tate indicated that to him it was the calendar coordination that was an issue. He inquired whether there is an automated way to coordinate meetings, having all Council Members calendars on the website?

Mayor Pro Tempore Carr said that the issue for him is calling special meetings. He stated that he has been frustrated that the Council works in a subcommittee fashion. He felt that Council members are appointed to subcommittees and then a majority of the Council decides that it wants to attend a subcommittee meeting. This results in the City Clerk's office being forced to call the special meeting, agendize the meeting, send notice of the meeting to the newspaper and others. He noted that a few weeks ago, the City Council had a slue of special meeting minutes which the Council was to approve. As he read through the minutes, he noted that most meetings had one Council Member or the Council Chair of the subcommittee in attendance, and in some instances, no Council Members in attendance. He felt the Council needs to be honest and prudent when it appoints Council Members to subcommittees. If all Council members want to be part of the subcommittee, he felt that it should be so indicated at the dias. This may result in the Council deciding not to appoint a subcommittee and working on the issue as a Council. He does not like to miss Council meetings, or to give the impression that he is not doing the work that he has been asked to do by the public. He recommended a uniform means of calling meetings be established. He said that there have been meetings called that did not go through the proper channels, noting that a policy is in place which allows for special meetings to be called by the Mayor or three Council members. He recommended that the formal policy be used and respect be paid to each others time.

Mayor Kennedy said that part of the problem is where there is a public meeting which more than two Council members would like to attend. He noted that it is the City Attorney's opinion that the meeting has to be posted as there may be a potential for Council policy discussion.

City Manager Tewes said that it is clear that when a majority of Council members wish to attend a subcommittee meeting to discuss city business, it would result in a majority of the City Council

discussing city business. This would result in the need to call a special meeting. He said that the conservative approach where it is uncertain whether city business will be discussed, and a majority of the Council will attend, is to post the meeting.

Council Member Sellers concurred with Mayor Pro Tempore Carr on this issue. He recommended a policy such that should a council member wish to have a meeting held, it should be brought to the entire Council's attention through the City Manager and that he bring it up at a Council meeting. The Council should be prepared to have its calendars at the meetings so that the Council can discuss meetings in a formal way. He felt that meetings are being called that should not be called and are being called informally. In other instances, a council member wishes to meet with a citizen's group. This results in council members being called to attend informal meetings. He indicated that every week he receives a number of calls from staff confirming his attendance at meetings. He recommended that a policy be established that defines how special meetings are to be called. It was his belief that there are cities that have master calendars that can be accessed through the web site.

Council Member Chang inquired what would happen if she is called to see if the Mayor and other council members can attend a group meeting?

Council Member Sellers felt that it should be clear that a Council member should go through the City Manager to discuss scheduling a special meeting at a Council meeting. If this is not clear to council members, he felt that a policy should be adopted by the Council that sets forth the process for scheduling special meetings.

Council Member Chang indicated that she was not clear as to the process for calling special meetings. She indicated that she contacted every council member regarding their availability to attend a special meeting because she felt that none of the council members would want to be excluded from the meeting. She said that she is starting to feel that the Council is not working together. She indicated that there are times when she is unable to attend special meetings and she has not requested that the meetings be held because the meetings were not convenient for her. She requested that the council work together as she is looking forward to two more years together.

Council Member Tate felt that Council Member Sellers offered good suggestions and would address Mayor Pro Tempore Carr's concerns.

City Manager Tewes clarified that there was also policy discussion about circumstances in which the Council would appoint a subcommittee. To be clear that if the Council appoints a subcommittee, it is the intention to ask the subcommittee to take the lead on the matter/issue, otherwise, the Council is not to appoint a subcommittee.

Council Member Chang indicated that the Woodland Mobile Home Park residents are inviting Mayor Kennedy and the Council Members to attend a meeting. It appears that all Council Members are available next Monday. She noted that Mayor Kennedy and Council Member Sellers are the

members serving on the Medical Services and could attend the meeting. Other Council Members can attend as citizen members or the Council can call a special meeting.

Council Member Tate questioned the need for a meeting on Monday when the Council will be presented with a report from the Morgan Hill Community Health Foundation on Wednesday night regarding medical services.

Mayor Pro Tempore Carr requested that should the Council appoint a subcommittee, that the Council let the subcommittee take the lead.

Council Member Tate recommended that staff look into having Council calendars on the web.

Mayor Kennedy said that he looks at this meeting as receiving the Woodland Mobile Home Park residents' comments before meeting with John Ray and the medical foundation.

Mayor Kennedy opened the floor to public comment. No comments were offered.

Action: **No action taken.**

City Council Action

CLOSED SESSION:

City Manager Tewes informed the City Council that City Attorney Leichter had to excuse herself from the remainder of the meeting. He said that City Attorney Leichter indicated that the closed session items could wait to another meeting date.

1.

CONFERENCE WITH LEGAL COUNSEL - EXISTING LITIGATION

Authority:	Government Code section 54956.9(a)
Case Name:	City of Campbell et al. v. CalPERS
Case Number:	OAH 5119
Attendees:	City Attorney, City Manager

2.

CONFERENCE WITH LEGAL COUNSEL - EXISTING LITIGATION

Authority:	Government Code section 54956.9(a)
Case Name:	Allivato v. City of Morgan Hill et al.
Case Number:	Santa Clara County Superior CV 810111
Attendees:	City Attorney, City Manager

OPPORTUNITY FOR PUBLIC COMMENT

No comments were offered.

FUTURE COUNCIL-INITIATED AGENDA ITEMS:

No items were noted.

ADJOURNMENT

There being no further business, Mayor Kennedy adjourned the meeting at 11:10 p.m.

MINUTES RECORDED AND PREPARED BY

IRMA TORREZ, City Clerk